Supreme Court, U. S.
FILED
AUG 1 1975
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-799

UNITED STATES OF AMERICA,
Petitioner,

vs.

FOSTER LUMBER COMPANY, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE RESPONDENT

QUESTION PRESENTED

For income tax purposes a corporation is entitled to carry a net operating loss three years back and five years forward until the loss is absorbed. Whenever a year to which the loss is carried does not have sufficient ordinary income to absorb all of the loss, but has a capital gain required to be taxed at the 25% "alternative tax" rate provided for in Section 1201(a) of the Internal Revenue Code, the remaining loss not absorbed by ordinary income does not diminish the capital gain subject to the 25% tax.

In such a case, does the taxed capital gain absorb loss, or is the amount of the loss in excess of the ordinary income of the year available for use in a later year?

STATEMENT OF THE CASE

This is a tax refund case. Respondent[1] claimed a Federal income tax refund for its fiscal year ended March 31, 1967, based upon a net operating loss deduction[2] resulting from a carryback of a later year's net operating loss.[3] The Internal Revenue Service denied the claim for refund on the ground that the net operating loss in question had been fully "absorbed" in fiscal 1966 leaving no net operating loss deduction in fiscal 1967 under its interpretation of the applicable statute. The question in this case therefore concerns "absorption" in fiscal 1966. Under Section 172(e) (all section references herein are to the Internal Revenue Code of 1954 unless otherwise indicated) the question is to be decided under the law applicable to that taxable year.

Table A following extracts from the Appendix (A. 14) the applicable income, loss, and capital gain figures, stated by years.

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1. Respondent in fact is the successor to Foster Lumber Company, the taxpayer involved. (A. 14) The term "Respondent" as used herein includes the predecessor corporation.

2. The "net operating loss deduction" is the sum of the net operating loss carryovers and carrybacks to the year. INT. REV. CODE OF 1954, §172(a).

3. A "net operating loss" in general is a net operating loss carryback to each of the three taxable years preceding the loss year and a net operating loss carryover to each of the five taxable years following the loss year. Sections 172(b)(1)(A) and (B). The net operating loss must be carried initially to the third preceding taxable year; then to the extent not used to offset income, it is carried to later years in chronological order. INT. REV. CODE OF 1954, §172(b)(2).

TABLE A

Applicable Income, Loss and Capital Gain Figures Stated by Years

Taxable Year Ended	Ordinary Income	Capital Gain	Total
3/31/66	$ 7,236	$166,635	$173,871
3/31/67	114,262	114,656	228,918
3/31/68	—(Irrelevant—Not Stipulated)—		
7/19/68	(42,203)	–0–	(42,203)
3-Year Totals	$ 79,295	$281,291	$360,586

As Table A shows, the net operating loss occurred in Respondent's short taxable year ended July 19, 1968.[4] The amount of that loss, $42,203, was carried back first to fiscal 1966, creating in that year a net operating loss deduction. In that year, Respondent had, prior to the application of the net operating loss deduction, net ordinary income of $7,236 and a capital gain of $166,635.[5] The parties agree that a portion of the net operating loss deduction was applied against and erased the $7,236 of ordinary income. However, neither the capital gain of $166,635, nor the 25% tax assessed against it under the alternative tax computa-

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4. It perhaps should be mentioned that Respondent also had a 12-month taxable year ended March 31, 1968; otherwise, the reader may question whether fiscal 1966 was the third taxable year preceding the loss year.

5. Throughout this brief, the excess of net long-term capital gain over net short-term capital loss is referred to as "capital gain." All other taxable income resulting when net operating loss deductions are not taken into account is referred to as "ordinary income" or "ordinary operating income."

tion of Section 1201(a),[6] was affected by the remainder (approximately $35,000) of the available net operating loss deduction.

The question presented is whether the $35,000 was absorbed by the existence of the capital gain in fiscal 1966, or whether it remains available to reduce the ordinary income of fiscal 1967.

SUMMARY OF ARGUMENT

The purpose of Section 172, as shown clearly by its legislative history and the decisions construing it, is to ameliorate the tax consequences of fiscal year taxation for taxpayers with earnings which fluctuate sharply from profit to loss. Section 172 is structured to accomplish this purpose by allowing a deficit in income for one tax year to be deemed a "net operating loss deduction", which may be deducted from earnings in the preceding three and subsequent five taxable years (as if the earnings and deficits had been more evenly distributed).

The alternative tax provisions in Section 1201 have an equally clear purpose: to place an effective ceiling on the tax assessable against long-term capital gain by segregating it from ordinary income for taxation at a special rate (25% at the time in question), whenever such separate taxation produces a lower aggregate tax for the year.

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6. Act of Oct. 16, 1962, Pub. L. No. 87-834, §8(g)(3), 76 Stat. 999, *amending*, Int. Rev. Code of 1954, ch. 736, §1201(a), 68A Stat. 320, *as amended*, INT. REV. CODE OF 1954, §1201(a). All references to Section 1201 will be to this version, which was effective for Respondent's 1966 taxable year.

It is undisputed that when one of the eight years over which deficits in earnings may be distributed as a "net operating loss deduction" under Section 172 is also a year in which the taxpayer has a capital gain and the alternative tax is lower, the net operating loss deduction may be used to reduce only the income which is taxed at regular tax rates under the "partial tax" provisions of Section 1201. The net operating loss deduction has no effect on the segregated capital gain component of income or on the separate tax assessed against it.

Because a portion of the net operating loss deduction is carried onward from year to year until it is exhausted (or until the carryover period elapses), it is necessary to determine whether the portion of the net operating loss deduction which may be carried to years subsequent to an alternative tax year is (a) the portion which exceeds the ordinary income from which it may be and has been deducted; or (b) the portion which exceeds the *sum* of that income *plus* the unaffected, segregated capital gain, from which it is *not* deductible and has not been deducted.

The first of these constructions serves the purpose of Section 172 by preserving equal treatment between taxpayers similarly situated during the carryover period except for the timing of capital gains; and also serves the purpose of Section 1201 by preserving the ceiling on the tax rate for capital gain.

The latter, Government construction creates unequal tax results between taxpayers distinguished only by whether and when they experience capital gain, and thus contravenes both (a) the equalizing function of Section 172, by making the fiscal year in which the capital gain occurs govern tax consequences; and (b) the function of

Section 1201, by making the occurrence of a capital gain cause the loss of the tax benefit in subsequent years of a pre-existing net operating loss deduction, thereby effectively nullifying the ceiling on capital gain taxes.

The Tax Court, the court below, and two other circuits have construed the language of the second sentence of subsection 172(b)(2) to be compatible with the construction required to effect the legislative purpose. Those courts. and Respondent, read the sentence as providing that the amount of the potential deduction remaining after its application in one year is the excess of the net operating loss over that part of the year's income from which it may be deducted, i.e., in an alternative tax year, over the income on which the partial tax is assessed. In light of such authority, the Government's principal contention, that the language of the sentence permits no such construction, is without force.

The Government's observations regarding the difference which exists, under Respondent's construction of Section 172, between the computations determining (a) the net operating loss to be carried to other taxable years, and (b) the portion of a loss so determined which remains to be deducted in taxable years subsequent to an alternative tax year, are not instructive, because such differences are inherent in the statutory scheme. The Government's assertion that the decision below creates a disparity of treatment between individual and corporate taxpayers simply derives from a misunderstanding of the computations prescribed by the statutes. Its contention that Congress intended a lesser tax benefit than that granted by the decision below arises from an invalid inference from a fragment of legislative history viewed out of context.

Respondent was thus entitled to the refund claimed and awarded below.

ARGUMENT

Preliminary Statement on the Decisions Below and on the Structure of the Argument.

The technical tax question presented arises at the intersection of two widely separated divisions of the Internal Revenue Code, each having distinct objectives: (i) Section 172, providing for loss spreading so that a taxpayer with fluctuating operating results is allowed to treat operating losses concentrated in one tax year as if they had been distributed over one or more (up to eight) additional years; and (ii) Section 1201, providing special tax treatment of capital gains.

Respondent encountered the intersection when it carried its 1968 net operating loss of $42,000[7] back to 1966, applied it there to absorb $7,000 of 1966 ordinary income, and then sought to apply the remaining $35,000 to ordinary income of the next year, 1967. Its application in 1967, and the consequent tax refund claimed, has been sustained by the courts thus far over the objection of the United States, which vigorously asserts that all of Respondent's $42,000 loss was "absorbed" in 1966, including the $35,000 of the 1968 loss which could not be applied in any meaningful manner in 1966. There was a $167,000 capital gain in 1966. According to the Government, its presence in that year caused the absorption of all the net operating loss. Yet, the parties agree that the actual capital gain of $167,000 and the 25% tax imposed thereon by the alternative tax provision of Section 1201(a) was not reduced by the presence

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7. See Table B which rounds figures to thousands of dollars. The rounded figures are normally used hereinafter.

of the $35,000 balance of the loss carried back,[8] since it is the long established rule that no deficit in ordinary income may be used to reduce capital gain when the alternative tax applies.[9]

The issue of absorption posed by this case may arise in any of the eight years to which Section 172 permits the carrying of losses, except the last.

The court below[10] ruled in accordance with an unwavering line of authority from the Tax Court,[11] the circuits,[12] and district courts,[13] that a corporate taxpayer is

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8. *See, e.g.*, Petitioner's Brief at 30-31, 32 [hereinafter cited as G.Br.].

9. *Chartier Real Estate Co.*, 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970) ("carry" years); *Walter M. Weil*, 23 T.C. 424 (1954), *aff'd*, 229 F.2d 593 (6th Cir. 1956) (loss year).

10. *Foster Lumber Co.* v. *United States*, 500 F.2d 1230 (8th Cir. 1974).

11. *Chartier Real Estate Co.*, 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970), was the Tax Court's first decision of the issue and has been followed consistently by the Tax Court in all later cases. *See Sidney Axelrod*, 32 CCH Tax Ct. Mem. 885 (1973), *rev'd*, 507 F.2d 884 (6th Cir. 1974); *Mutual Assurance Soc'y*, 32 CCH Tax Ct. Mem. 839 (1973), *rev'd*, 505 F.2d 128 (4th Cir. 1974).

12. *Olympic Foundry Co.* v. *United States*, 493 F.2d 1247 (9th Cir. 1970) (per curiam); *Chartier Real Estate Co.* v. *Commissioner*, 428 F.2d 474 (1st Cir. 1970) (per curiam). After the *Foster Lumber* decision, this line of authority was followed in *Data Products Corp.* v. *United States*, No. ..... (9th Cir., Dec. 27, 1974), *petition for cert. filed*, 43 U.S.L.W. 3454 (U.S. Feb. 10, 1975) (No. 74-996). *Axelrod* v. *Commissioner*, 507 F.2d 884 (6th Cir. 1974), and *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974), were decided subsequent to the *Foster Lumber* decision.

13. *Naegele* v. *United States*, 32 Am. Fed. Tax R.2d 73-5689 (D.Minn. 1973), *appeal docketed*, No. 73-1921, 8th Cir., Dec. 26, 1973; *Olympic Foundry Co.* v. *United States*, 29 Am. Fed. Tax R.2d 72-759 (D.Wash. 1972), *aff'd per curiam*, 493 F.2d 1247 (9th Cir. 1974).

not deprived of all or part of the tax benefit of an operating loss carryback or carryover merely because it happened to experience a capital gain in a year to which a net operating loss from another year is carried. The Government here contends the contrary, relying primarily on a subsequent decision in which the Fourth Circuit reversed the Tax Court.[14]

The decision below, in favor of the taxpayer, was founded on the conclusion that it is impossible to find any plain meaning in the statutory language, but that "the basic policy considerations underlying Sections 1201 and 172 decisively support the result reached by the district court," in favor of the taxpayer. 500 F.2d at 1232. In support of this conclusion, the court observed that "to hold otherwise would frequently subject otherwise similarly situated taxpayers to significantly different treatment solely on the basis of arbitrary timing; precisely the reverse of Section 172's original purpose." 500 F.2d at 1232.

Although the Court of Appeals did not give a specific example of the arbitrary consequences of timing if the Government's contention were accepted, this phenomenon can be illustrated by simple adjustments to Table B, on the following page, which illustrates Respondent's pertinent income history in numbers rounded to the nearest $1,000.

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14. *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974).

TABLE B

Applicable Income, Loss and Capital Gain Figures of Respondent, Stated by Years and Rounded

Taxable Year Ended in	Ordinary Income (Net)	Capital Gain	Total
1966	$ 7,000	$167,000	$174,000
1967	114,000	115,000	229,000
1968*	(42,000)	–0–	(42,000)
3-Year Totals	$ 79,000	$282,000	$361,000

If the taxpayer's $167,000 capital gain had been realized in 1967 rather than in 1966, even the Government would concede that the taxpayer's 1968 NOL of $42,000 would be applied first to the 1966 ordinary income to the extent of $7,000 and then to the 1967 ordinary income to the extent of the remaining $35,000, with the result that the total amount of income taxed over the three-year period would be $361,000—the taxpayer's actual net economic gain for the three years. Similarly, if the 1967 ordinary income had been realized in 1966, the Government would concede that the full amount of the 1968 loss could be carried back and applied against the hypothesized 1966 ordinary income of $121,000. This, too, would result in taxing a total of $361,000 over the three-year period, corresponding to the taxpayer's aggregate economic gain. Solely because the taxpayer's long-term capital gain was actually realized in 1966, and its ordinary income was small, the Government contends that the taxpayer's 1968 NOL was "absorbed" by capital gain, although this

*Refers to the pertinent year ended July 19, 1968. See note 4 and Table A, *supra*.

metaphysical "absorption" of the NOL did not reduce the 1966 alternative tax, and although such "absorption" makes the income taxed in the three years $396,000—$35,000 more than the taxpayer's net economic gain.

It would be ironic indeed if a statutory provision designed, as the court below observed, "to ameliorate the harsh tax consequences that can result from the necessity of accounting for certain exceptional economic events within the confines of an arbitrary annual accounting period" (500 F.2d at 1232), should have this precisely contrary effect.

Respondent feels it necessary to use a different sequence of presentation than the Government did, in order (1) to relate the issues more closely to the decision here for review; and (2) to identify and properly distinguish among the points which the Government Brief undiscriminatingly mixes together. For example, the Government has elected to disregard the policy-oriented basis of the decision below and to organize its arguments to emphasize bare syntactical arguments directed at a "straw man". The first and lengthier of the Government's two enumerated arguments (G.Br., pp. 17-28) consists almost exclusively of a grammatical analysis of the phrase "the excess . . . of the amount of such [net operating] loss over the sum of the taxable income for each of the prior years to which such loss may be carried."[15] However, neither the decision

15. Quoted from Section 172(b)(2), which reads:

"Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. *The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.*" (Emphasis added.)

here for review nor the acknowledged leading decision of the Tax Court, *Chartier Real Estate Co.*, 52 T.C. 346 (1969), aff'd per curiam, 428 F.2d 474 (1st Cir. 1970), is based, as the Government strains so greatly to imply (e.g., G.Br., pp. 8-9, 20), on a conclusion that the phrase "to which such loss may be carried" modifies "taxable income."

Rather, each of the decisions is explicitly grounded in a nonlinguistic, practical analysis of the purposes of the statute and the consequences of alternative readings (500 F.2d at 1232; 52 T.C. at 347-48). On that basis, *Chartier* stated its interpretation of Section 172(b)(2) in terms of how much of the clause *is to be taken* as modified by its final phrase. 52 T.C. at 347-48. The decision below treats the grammatical paraphrase of the matter as merely an alternative, shorthand means for stating the issue. 500 F.2d at 1232.

As will be demonstrated, and as the decision below made clear, the construction advocated by the Government would subvert the purposes for which the NOL carryover and alternative tax provisions were enacted and have been repeatedly reenacted since their appearances on the statute books in 1918 and 1942 respectively.

I. The Decision Below Effectuates the Purposes of Both of the Relevant Statutes.

Two separate sections of the Code are involved here, although only one requires construction. Each has a distinctive legislative history and functional role in the tax laws. The primary focus of Section 172 is operating losses, i.e., excess deductions of the sort which reduce ordinary income which is taxed to corporations at the rates specified in Section 11. Section 1201 functions primarily to limit the tax burden imposed on capital gains.

The design of the alternative tax is such that capital gains are taxed to corporations at the normal, Section 11 rates, only when the corporation has such a small total net income that rates lower than the 25% corporate capital gain rate apply, i.e., where the surtax rates imposed by Section 11(c) are invoked for so slight an excess of taxable income over the $25,000 surtax exemption that the total effective tax rate is less than 25%. As the Government notes in a footnote (G.Br., p. 16n.7), (a) Section 11's rate structure during the period at issue was such that the tax rate on incomes up to $25,000 was 22%, and incomes above that sum were taxed at 48%; and (b) taxation under Section 1201 was more favorable and thus applicable unless the taxpayer's total net income was less than $28,260 if all in the form of capital gain. (Section 1201 could be more favorable for incomes between $25,000 and $28,260 which included some ordinary income.)

As will be seen under this Point, the distinct purposes of Sections 172 and 1201 can only be reconciled by the position taken by the court below.

A. The Purpose of Section 172, to Mitigate the Effects of Arbitrary Annual Accounting Periods, Compels the Result Below.

Three principal subdivisions of Section 172 determine its effects. Subsection (c) defines the "net operating loss" (NOL) which may be carried to other taxable years in unambiguous terms of "gross income" and "deductions allowed":

> "(c) Net Operating Loss Defined.—For purposes of this section, the term 'net operating loss' means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter

over the gross income. Such excess shall be computed with the modifications specified in subsection (d)."

The modifications made by subsection (d) will be discussed briefly hereinafter.

The NOL is made a deduction to offset profits from better years by subsection (a):

> "(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection."

The years to which an NOL generated in one tax year may be carried are currently defined by Section 172(b)(1) as the three years preceding the loss year, for any of which it is a "carryback," and the five years next following it, for which it is a "carryover."

The order in which the NOL shall be applied to each of the eight years prescribed, and the amount to be carried onward after each application, are established by Section 172(b)(2). It is the meaning of this subsection which is in dispute between the parties here:

> "(2) Amount of Carrybacks and Carryovers.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. *The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such*

> *loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.*" (Emphasis added.)

With respect to the italicized governing sentence, the court below properly observed that "it is impossible to find any plain meaning in the statutory language which would dispose of this controversy." 500 F.2d at 1232. Viewed separately from the legislative history and the context of its function, the bare language of the clause could be taken to mean that the NOL may be carried to each subsequent carryback or carryover year only to the extent that it exceeds "taxable income" (net ordinary income *plus* capital gain) for the year in which it has first been applied. Such a construction would serve adequately whenever the taxpayer's liability for the year of "absorption" (here 1966) has been determined under the regular tax provisions of Section 11, so that all income is taxed on the same basis and the NOL deduction will offset taxes up to the full extent of the income taxed.

However, where the "absorption" year is one in which the alternative tax applied, the Government's proposed construction results in "absorption" *without tax benefit,* since it is established that NOL deductions may not be used to offset capital gain income taxes at the alternative tax rate. *Chartier, supra* at 350-56.[16]

Respondent submits not only that the Government's proposed reading of the subsection is unconvincing on grounds of syntax (see Points II.-III., *infra*), but that this Court should reject a construction which renders the deduction in question nugatory in practice, particularly in the light of a consistent line of authority from the Tax Court

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16. The basis for the denial of the tax benefit is discussed at pages 36-38, *infra*.

and the Circuits, of which the decision below was a continuation.[17]

The first and leading decision in the area is *Chartier*, *supra*. There, in rejecting the taxpayer's contentions on the first of two consolidated petitions, the Tax Court held that when the alternative method of computing tax liability is required to be utilized in a given taxable year, a net operating loss carryback cannot be applied to reduce the the amount of capital gain subject to the alternative tax. Rather, the Court held, on the second petition, that the loss carryback is "carried" only to income subject to the partial tax at Section 11 rates and from which it may be deducted; any portion of the NOL not applied against such income to yield a tax benefit is carried onward to another year's return.

The Government was seeking in *Chartier*, as here, to have the best of both worlds—arguing, first, that in an alternative tax year the loss carryback could not be applied to reduce capital gain, and, second, that the carryback nevertheless was "absorbed" by the capital gain so as to preclude its availability as a deduction against other income in a later year. The Tax Court rejected the second Government position, concluding that the commands of the alternative tax provision and the policy underlying the net operating loss provision could encompass the former position, but, having done so , precluded the latter.

In accepting the Government's first argument—that the carryback cannot be applied to reduce capital gain in an alternative tax year—the Tax Court observed that the alternative method "creates an artificially separate tax on capital gains which ignores ordinary income and deductions." 52 T.C. at 356. At the same time, in explaining the reason why any excess carryback must then remain available to reduce income subject to the regular tax in succeeding carryback years, the court stated:

> "Provisions for applying net losses from one taxable year to other taxable years have been a part of the tax law since 1918. See sec. 204, Revenue Act of 1918. The purpose of such provisions is obviously to ameliorate somewhat the arbitrary nature of the annual accounting period, especially in the case of businesses with great fluctuations in income from year to year. Thus, section 172 is clearly designed to allow taxpayers, within the limits of the periods specified, to offset profits from one year with losses from other years *in computing their tax liabilities.*" 52 T.C. at 357 (Emphasis added.)

The court went on to say:

> ". . . in keeping with the purpose of section 172, the remaining [NOL] should be used to offset gains in other years to which it may be carried. We think that nothing in that section prohibits the carry-forward of that amount to the year ending June 30, 1962. The pertinent sentence in section 172(b)(2) is 'The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.' We agree with petitioner's contention that the phrase 'to which such loss may be carried' modified 'taxable income' as well as 'each of the prior taxable years.' We further hold that 'taxable income' in this context (as modified by the above phrase) means that taxable income to which the loss is actually applied in computing actual tax

17. Cases cited in notes 11 and 12, *supra*.

liability. In this case, since the tax for petitioner's year ending June 30, 1962, was computed by the 'alternative' method, the only taxable income to which the loss could be carried was the $1,115.57 of ordinary income for that year." 52 T.C. at 357.

In other words, the Tax Court concluded that the policy behind Section 172 could be implemented only if any excess loss carryback in an alternative tax year, which they ruled had *no effect* in computing tax liability, must remain available as an offset against other income in subsequent years, where it could have an effect in computing tax liability. The court therefore refused to adopt the Government's almost metaphysical position that Congress' will could be done sufficiently if the deduction were taken into account in the academic exercise of computing the regular tax, notwithstanding that liability was determined under the alternative tax.

The First Circuit found the reasoning of Judge Raum to be so persuasive that it affirmed per curiam, stating: "It does not seem inappropriate to place a floor at the alternate tax, leaving unused losses to their carryover utility," and that Code Section 172(b)(2) "means that taxable income to which the loss is actually applied in computing actual tax liability." 428 F.2d at 475.

The thrust of the legislative history of the carryover provisions lends clear support to the Tax Court's views. Congress over the years has steadily expanded the tax relief available through the application of net operating losses. In the period before World War II when corporate tax rates were relatively low, ranging between 1% and 19%,[18] the need for operating loss relief was less pressing

18. The rate history for corporations is outlined in 1 J. MERTENS, THE LAW OF FEDERAL TAXATION §§2.12-.13 (perm. ed. rev. 1974).

and the congressional response was variable. With the commencement of World War II and the adoption of the Internal Revenue Code of 1939, tax rates on corporate net incomes began to increase dramatically.[19] Since 1950 the effective tax rate on corporate incomes above $25,000 has been as high as 52% and never below 40%.[20] Correspondingly, operating loss relief has been given and expanded. Appendix A sets forth the legislative history in more detail and shows that since the reintroduction of operating loss relief in 1939 the periods for carryovers and carrybacks have been expanded again and again—from the two-year carryover of 1939 until in 1958 the statute reached its present form, allowing a three-year carryback and a five-year carryover, with the stated purpose of giving nearly all corporations enough time "to absorb all of their losses against income."[21]

Thus, viewed over a span of 35 years, the Government's demand for a generally increasing share of corporate net income has been accompanied by increasing the loss availability period. In an effective way, Congress has shown that it does not intend the Government to be a partner of business only in the good years.

This Court has previously considered the function of Section 172, in *Libson Shops* v. *Koehler*, 353 U.S. 382 (1957), and emphasized the tax saving to be derived from the provision as follows:

"These provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush

19. *See* 1 J. MERTENS, *supra* note 18, §§2.12-.13.

20. 1 J. MERTENS, *supra* note 18, §§2.12-.13.

21. S. REP. No. 1881, 87th Cong., 2d Sess. 129 (1962).

years, and to strike something like an average taxable income computed over a period longer than one year." *Id.* at 386.

The Government's proposed reading of Section 172(b)(2) by which any excess of the available NOL deduction over the ordinary operating income for a year to which it has been carried is to be "absorbed" by capital gain, with *no* tax effect, and thereby eliminated as an available deduction for succeeding profit years, must be evaluated in the context of the legislative concern for achieving a fair tax on incomes which fluctuate.

B. The Purpose of Section 1201, to Tax Capital Gains at Lower Rates, Would Be Offended by a Rule Making the Realization of a Capital Gain Cause the Loss of the Benefit of an Operating Loss Carryover.

The "alternative tax," as a device for taxing the capital gain component of a taxpayer's income at a lesser rate than the ordinary income component, has existed in the Internal Revenue Code for nearly as long as operating loss carryover provisions. It first appeared in 1921[22] for individual taxpayers.

However, corporations were taxed on operating income and capital gains without differentiation until 1942, when the current pattern for corporations was established: When the alternative tax computation produces a lesser tax than Section 11, a corporation pays the total of a "partial tax" at Section 11 rates on the ordinary income component of its income, plus a 25% tax on the capital gain component. The development of alternative tax provisions is summarized in tabular form in Appendix B.

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22. Act of Nov. 23, 1921, ch. 136, §206(b), 42 Stat. 233.

It is notable that although the 1942 Revenue Act substantially reformed the existing alternative tax for individuals, it retained the then- and now-existing pattern whereby individuals, only, are *also* given favored treatment on capital gains under the regular tax provisions, in that only 50% of capital gains are deemed included in income for individual computations. See Section 1202, allowing 50% of such gain to be deducted, and Sections 1201(b)(1) and (2), removing the other (remaining) 50% from an individual's income subject to the partial tax, but including the entirety of capital gain in the amount subject to the 25% rate. Corporations have never been given such an additional benefit under the regular tax.

This fundamental difference between the capital gain treatments available to individuals and corporations is almost certainly the reason for the striking disparity between the degrees to which individuals and corporations use the alternative tax. Although it is mandatory for either variety of taxpayer when it is lower than the regular computation, in the period here at issue more than 98% of individuals reporting capital gain simply took the 50% capital gain deduction afforded by Section 1202, rather than paying under the higher (a fortiori) alternative tax computation in Section 1201(b).[23] In contrast, the mathematics of the situation compel nearly all corporations with capital gains to pay under the Section 1201(a) computation.[24]

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23. INT. REV. SERVICE, STATISTICS OF INCOME—1966, INDIVIDUAL INCOME TAX RETURNS 88 (1968).

24. In 1966, the principal year in question here, corporations paid taxes of $22 billion under the alternative tax method as compared with $12 billion under the regular tax method. INT. REV. SERVICE, STATISTICS OF INCOME—1966 CORPORATION INCOME TAX RETURNS 128-29 (1970).

The Government position, however, would subvert the policy of the alternative tax as markedly as it does that of the carryover provision: If the existence of a capital gain which invokes the presumptively favorable alternative tax computation also causes an NOL deduction to be "absorbed" without tax benefit, that capital gain, intended to be given favorable treatment of the 25% rate, will in fact deprive the taxpayer of relief from the normally higher Section 11 rates. Stated otherwise, the amount of capital gain which "absorbs" the excess NOL deduction is effectively taxed at up to 73% (!) i.e., at the sum of the 25% rate at which it is reported plus the 22% or 48% rates applicable to the ordinary income in a subsequent profit year, which the NOL would otherwise offset.

Such a result is necessarily contrary to the purpose of a statutory scheme structured to put a 25% ceiling on capital gain rates.

C. The Interpretation Sponsored by the Government would Destroy Equality of Treatment Between Taxpayers Similarly Situated Whenever a Capital Gain Occurs in a Year to Which an NOL May Be Carried.

In enacting tax legislation Congress concerns itself with the consequences of the enactment. This Court, and the lower courts, have repeated this principle with regularity. The classic case, of course, is *Gregory* v. *Helvering*, 263 U.S. 465 (1935), where the literal language of the statute would have compelled the conclusion that there was a nontaxable reorganization; but this Court refused to decide that Congress intended to legislate in a formalistic manner, saying in language not inappropriate here:

> "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470.

This Court has always proceeded on the assumption that "[t]axation is a practical matter . . ." (*Harrison* v. *Schaffner*, 312 U.S. 579, 582 (1941)) and that the taxing statute should be so approached. And where the overall intent of Congress to reach such a practical result is evident from the entire statutory scheme, the language of a particular section has received a broader interpretation than would follow if its literal language were the only insight into the congressional meaning. *Corn Products Ref. Co.* v. *United States*, 350 U.S. 46 (1956).

Syntax is a tool, not an end, and imprecisions of statutory language must be resolved by reference to the tax consequences of competing possible interpretations. The pattern intended to be created by Section 172 is clear from the legislative history cited above, and from its practical consequences in the normal run of cases: Congress intended to lessen the inequities in tax treatment between corporations with similar aggregate incomes over a 9-year period. While Congress has not specifically tailored a separate provision to deal with the intersection of an NOL and a capital gain, any syntactical ambiguity in the one sentence chosen to cover all contingencies should be resolved in favor of effecting the overall purpose.

The extent to which the Government's position would upset the purposeful pattern can be demonstrated by an example. The most general overview which can be obtained of the operation of Section 172 is to look at a full nine-year period as summarized in Table C. (The fourth year is the loss year; the NOL generated may be carried

back to the first three years and carried over to the last five.) The assumptions made, which do not detract from the generality of the illustration, are these:

(a) The amount of the loss in the loss year (year 4) is as great as the sum of the ordinary incomes in the other eight years. Only with this assumption can the full range of the nine-year period be used. It is assumed that the ordinary income is spread ratably among the eight profit years.

(b) A substantial capital gain is realized *once* during the nine-year period, of sufficient size that whenever it occurs the alternative tax computation is used to determine taxes.

Depending upon the year in which the capital gain is experienced, nine different situations arise. The question is: In each situation what are the respective tax effects under (i) Respondent's position, and (ii) the Government's position? The results are shown in Table C on the following page.

Table C

Effect of One-Time Capital Gain on Tax Benefit Derived From Net Operating Loss (Under Assumptions Stated in Text)

Year in Which Capital Gain Occurs	Result Under Respondent's Position	Result Under Government Position
1	Entire loss is used to offset ordinary income through the whole period.	1/8 of the loss is used to offset ordinary income in year 1. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 2, 3, 5, 6, 7, 8 and 9.
2	Entire loss is used to offset ordinary income through the whole period.	1/4 of the loss is used to offset ordinary income in years 1 and 2. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 3, 5, 6, 7, 8 and 9.
3	Entire loss is used to offset ordinary income through the whole period.	3/8 of the loss is used to offset ordinary income in years 1, 2 and 3. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 5, 6, 7, 8 and 9.
4 (the loss year)	None of the loss can be used to offset ordinary income in other years.*	None of the loss can be used to offset ordinary income in other years.*
5	Entire loss is used to offset ordinary income through the whole period.	1/2 of the loss is used to offset ordinary income in years 1, 2, 3 and 5. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 6, 7, 8 and 9.
6	Entire loss is used to offset ordinary income through the whole period.	5/8 of the loss is used to offset ordinary income in years 1, 2, 3, 5 and 6. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 7, 8 and 9.
7	Entire loss is used to offset ordinary income through the whole period.	3/4 of the loss is used to offset ordinary income in years 1, 2, 3, 5, 6 and 7. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in years 8 and 9.
8	Entire loss is used to offset ordinary income through the whole period.	7/8 of the loss is used to offset ordinary income in years, 1, 2, 3, 5, 6, 7 and 8. Loss gives no further tax benefit. Taxpayer pays ordinary income taxes in year 9.
9	Entire loss is used to offset ordinary income through the whole period.	Entire loss is used to offset ordinary income through the whole period.

*"Loss" continues to mean the ordinary income deficit. When the capital gain occurs in year 4, there is no "net operating loss" as defined in Section 172(c).

Certainly Section 172, which was intended to equalize to a greater extent the tax burdens as between corporations with fluctuating income and corporations with stable income, should not be read to result in the anomalous situation which results under the government's view. Under that position, eight taxpayers with an identical economic performance over the 9-year period are treated in eight different ways under the tax law. Respondent's position, on the other hand, results in treating the eight different corporations who have a net operating loss in year 4 and have identical economic performance over the 9-year period in exactly the same way.

The United States emphasizes the fourth year and the fact that there is no NOL as defined in subsection 172(c) if the capital gain occurs in that year. Congress has explicitly stated its intention to exclude the corporation which experienced its capital gain in the fourth year from a net operating loss benefit. See Point III. A., *infra*. In contrast, there is nothing in the decisions or in the legislative history to justify the result which follows from the Government's position: That each of the other eight years, in which some net operating loss benefit is conferred, should be treated differently from one another. It is self-evident that the Government's position, far from rationalizing the loss carryover provisions, would introduce a major new set of irrationalities.

II. The Statutory Language Is Consistent With the Result Below.

Because the Government Brief failed to discuss seriously the congressional objectives or to provide the Court with an overview of the tax consequences which will flow from its position, it has been necessary for the Respondent to do so first. Respondent will now address the main

Government point, relating to syntax and the meaning of the words appearing in the second sentence of Section 172(b)(2):

> "The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried."

A. The Decision Below Did Not Construe the Words "Taxable Income" Standing Alone.

A substantial portion of the Government's Brief (G.Br., pp. 12-23, 26-28) is devoted to the proof of a proposition with which neither the Court below, the Tax Court (in *Chartier*), nor Respondent has disagreed: that "taxable income" means "taxable income" as defined in Section 63(a). The entire proof is directed to an extraneous non-issue. Respondent's contention is that the basic congressional objectives in enacting Section 172 require that "taxable income . . . to which the loss may be carried" in Section 172(b)(2) be read together, and that, so read, it means something quite different from what "taxable income" would mean standing alone. "Taxable income" also appears as part of a phrase in Section 1201, where it is similarly necessary that it be modified to produce the result Congress intended.[25]

In an apparent effort to make its argument appear more pertinent, the Government Brief distorts the holding of the court below on at least two occasions. At one point, it refers to "[t]he Court of Appeal's restriction of 'taxable income' to ordinary income. . ." (G.Br., p. 20), and at

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25. The version of section 1201(a) effective in 1966 assesses the partial tax on "taxable income reduced by such excess."

another to the "decision below" as "holding that the term 'taxable income' means only ordinary income in the case where the alternative tax is applicable . . ." (G.Br., p. 27). In fact, the Eighth Circuit made no attempt to construe the words "taxable income". It did approve the strict policy grounds of the decision in *Chartier*, which result in reading the sentence so that the phrase "to which the loss may be carried" modifies "taxable income", and by which the entire phrase "taxable income . . . to which the loss may be carried" can refer only to ordinary income subject to the partial tax, when the alternative tax applies. Nonetheless, the Eighth Circuit itself spoke of the matter before it in grammatical terms only as an alternative means of stating the issue to be resolved:

> Stated somewhat differently, the issue in this case is whether the last phrase of section 172(b)(2), "to which such loss may be carried" modifies "taxable income" as well as the words "prior taxable years". 500 F.2d at 1232.

This passage merely acknowledges one of the ways in which the Tax Court in *Chartier* defined the thrust of its decision. See 52 T.C. at 357-358.

B. The Statutory Language Is Consistent With the Construction Below.

Respondent submits that the court below was correct in its view that the language of the pertinent second sentence of Section 172(b)(2), is, as a matter of abstract syntax, susceptible to either of the constructions sponsored by the respective parties: the sentence is amenable to a reading whereby the phrase "to which such loss may be carried" modifies "the sum of the taxable income for each of the prior years," and is also amenable to one whereby

it modifies only "each of the prior years". However, Respondent further submits that, even apart from the reasons of policy already discussed, the statutory context in which the subject sentence appears indicates that the phrase is intended primarily to modify "taxable income".

The second sentence of the subsection is a part of Section 172 as a whole, and should be read to be consistent with the subject matter and structure of the section in its entirety. The subject matter of Section 172 is a system under which ordinary losses are spread to be deducted from available income taxed at Section 11 rates. Indeed, that system had been established under Section 172 and its predecessors for nearly a quarter of a century before the 1942 corporate alternative tax came into being[26] and first created a category of corporate capital gain to be taxed at more favorable rates. The link between operating losses and Section 11 income is one too inherent in Section 172 for one to readily accept that the language of subsection (b)(2) was not chosen to incorporate it.

Respondent's proposed construction yields a sentence readily paraphrased in pertinent part as: "taxable income to which losses may be carried and applied to reduce the tax." The only meaningful sense in which an NOL is "carried" is that it is transferred from a tax return in which there is nothing left from which it may be deducted to a tax return on which it is useful as a deduction. In other words, an operating loss is "carried" through the designated years in sequence to income from which it may be deducted. That, of course, is the meaning the Court of Appeals gave the sentence.

The Government's proposed construction, under which the sentence directs only that an NOL is carried to a

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26. See Appendix A.

year, would make the subject phrase trivial, or mere surplusage, since the preceding subsections (a) and (b)(1) have already directed that the NOL shall be carried to each of the eight years they specify. The subject of the second sentence of subsection 172(b)(2) is the "portion" of an NOL remaining to be carried to subsequent years. The deduction will not have been reduced, so that a "portion" of it remains, except in the course of being used in one of the years so defined in which it *could* be used. Thus, there is no need for subsection (b)(2) to limit the "portion" in terms of the *years* to which it may be or has been carried. A "portion" of the loss will remain only after it has been *used* in part as a deduction against taxable income.

Additional support for Respondent's view comes from Section 1201. Except where, as here, the carryover provisions also apply, the Government must surely agree that the prescribed alternative tax computations observe a hard line between (a) ordinary income to be taxed at Section 11 rates "as if this subsection had not been enacted", and (b) capital gain, to be taxed at special, preferential rates. The two categories are defined so that the ordinary income is called "taxable income reduced by the amount of such excess," since it is necessary to remove "such excess" from what is "taxable income" for Section 11 purposes, in order to segregate the "excess" for "an artificially separate tax on capital gains which ignores ordinary income and deduction". *Chartier*, *supra* at 356. Thus, Congress has shown that in contexts where the two-step alternative tax applies, the broad term "taxable income" is not usefully descriptive. Some modifier is necessary to distinguish the "partial" income still taxable at Section 11 rates after Section 1201 has segregated the capital gain for separate treatment.

Respondent submits that the modifying phrase "reduced by such excess" in Section 1201 serves to accomplish the same result as does the phrase "to which such loss may be carried", in Section 172(b)(2), each in the characteristic language reflecting the principal subject matter of its respective section. Stated otherwise, "taxable income for each of the prior years to which such loss may be carried" describes in terms of "carried" losses precisely what "taxable income reduced by such excess" describes in terms of the "excess" which is segregated for separate taxation.

If the regular tax applies in the "carry" year, it makes no difference whether the phrase "to which such loss may be carried" primarily modifies "taxable income", as *Chartier* ruled it must, or "prior taxable years", as the Government contends. When the regular tax applies, there is no ambiguity: all (net) income in the "carry" year is "taxable income . . . to which the loss may be carried," and from which it is deductible.

The difference between the parties' positions is material only when there is in the "carry" year a capital gain sufficient to invoke the alternative tax, i.e., when Section 1201 also applies. Only then does the phrase "to which such loss may be carried" serve a useful function. Then, it is necessary to conform the usage in Section 172(b)(2) to that which pertains in Section 1201: The bare term "taxable income", defined in Section 63(a) and made a tax base in Section 11(a), includes the capital gain. If the line of demarcation provided by Section 1201 is to be observed—between (1) ordinary income, to be taxed "as if this subsection had not been enacted", and (2) capital gain, which the section directs to be taxed at a single, quite different rate—it becomes necessary when the al-

ternative tax is invoked to qualify the Section 11(a) language (which otherwise serves adequately by itself when the regular tax applies). The phrase "to which such loss may be carried" serves in alternative tax years to qualify "taxable income" to conform to the meaning it has, as similarly qualified, in Section 1201.

The conclusion that the final phrase of the sentence is to be read as integral with "taxable income" in the pertinent sense is necessary to the legislative purpose, as *Chartier* and the decision below hold. As the Tax Court in *Chartier* declared, it is "not prohibited" by the statutory syntax; it is justified by the foregoing analysis of content and usage.

III. The Supposed Anomalies of the *Chartier* Rule, Advanced by the Government, Involve No Inconsistency and Do Not Support the Government Position.

Although by far the greater portion of the Government's Argument is devoted to its argument, based on syntax (see Point II, *supra*) one portion of its Point B and all of its Point C do purport to reach questions of the purpose of Section 172 as manifested in some aspects of its structure and effect.

For clarity in the following response, it is necessary as a preliminary matter to point out that the Government misuses the basic terminology of the subject matter throughout its Point C. Even the caption of the Point (G.Br., p. 28) shows the error: "Respondent Did Not Have a Loss *Carryover from 1966 to 1967*". (Emphasis added.) There is no question here of a *carryover* from 1966. The question is what carryback Respondent had from 1968

to 1967, after its 1968 NOL was carried back to 1966.[27] Subsection 172(b)(1) does not tolerate such misuse.[28]

The resulting confusion makes it uncertain whether the Government intends its arguments in this area to be taken literally (in which case they are invalid) or as policy arguments by analogy. The response in A, B, and C following considers them as arguments by analogy despite the Government's failure to acknowledge their nature as such.

A. The Computation of the Net Operating Loss Generated in a Loss Year Is Required by Express Provisions to Be Different From the Computation of "Absorption" in a Carry Year.

The Government correctly points out that a deficit in ordinary income will not produce an NOL if there is a capital gain in that year, unless the deficit is also greater than the capital gain. Section 172(c) so provides.

The Government argues from the *assumption* that Congress intended the very different language of Section 172(b)(2) to give a parallel result. G.Br., pp. 28-30. In fact, each time Congress has spoken on the subject since 1918 it has provided a different calculation of the amount of the NOL generated in the loss year than it provided for determining the amount of the NOL remaining after it has been carried to each profit year. A modern illustration of the difference is Section 172(d), which is incorporated

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27. The misuse recurs throughout Part C of the Government Brief: The five-page argument refers four times to a "carryover to 1967", three times to a loss "carried forward to 1967", and once to a loss "carried from" a non-loss year.

28. Subsection 172(b)(1) declares that a net operating loss "shall be a . . . carry*back* to each of the three taxable years preceding . . ." and a "carry*over* to each of the five taxable years following such loss".

by reference into Section 172(c): It enumerates six modifications to be made in the loss year computation, of which three are expressly made inapplicable in "carry" years by Section 172(b)(2)(A).[29]

Congress unquestionably desired to impose strict standards on the determination of whether there is a "net operating loss" in the first instance. However, once the loss threshold has been reached and a "net operating loss" comes into existence, an entirely different set of rules contained in Section 172(b)(2), reflecting different policy considerations, governs the application and absorption of that loss. The Government's reliance on Section 172(c) is thus totally misplaced.

B. The Decision Below Creates No Disparity Between Corporate and Noncorporate Taxpayers.

The last part of the Government's Point B (G.Br., pp. 27-28) is devoted to the proposition that the Tax Court position, adopted by the court below, would "accord markedly better treatment for corporations than individuals," because Section 172(d)(2)(B) requires that the Section 1202 "deduction" for individuals (50% of capital gains) not be "allowed," and thus for an individual taxpayer, "the full amount of ordinary income plus capital gains will be offset against the operating loss."

While Respondent can see no reason why corporate and noncorporate taxpayers must necessarily be treated equally (as they are not in many areas of the Code), the decision below would *not* produce different treatment for individuals than for corporations. The individual treatment

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29. Those enumerated in Sections 172(d)(1) [net operating loss deductions], (4) [various personal, non-business deductions], and (6) [deductions for dividends received by corporations].

which the Government compares to that granted corporations comes into being "under *Axelrod* v. *Commissioner*" (G.Br., p. 27), a recent decision of the Sixth Circuit which, by dictum, rejects the *Foster Lumber* decision in favor of *Mutual Assurance*. *Axelrod* thus anticipated that *both* individuals and corporations would suffer "absorption" without benefit, as the Government here proposes. In a parallel manner, the Tax Court in *Chartier* adopted the individual rule from *Weil* for corporations; and, when the occasion subsequently arose, it held that individuals would be afforded the same tax benefit as *Chartier* afforded corporations. *Sidney Axelrod*, 32 CCH Tax Ct. Mem. 885 (1973), rev'd, 507 F.2d 884 (6th Cir. 1974).

Therefore, the Government's point is no more than that *Mutual Assurance* and *Axelrod* v. *Commissioner* have created a division in the circuits.

Respondent's position clearly produces like treatment for both types of taxpayers. When the regular tax applies in the "carry" year, Section 172(d)(2)(B) functions to create *equality* between individual and corporate taxpayers. In such a year, Section 172(d)(2)(B) compensates for the difference in corporate and individual taxpayers' respective taxable incomes, which is created by the availability of the Section 1202 deduction to individual taxpayers only. Section 172(d)(2)(B) does so by providing that, for purposes of determining the amount of income which can "absorb" an NOL, that deduction shall be disregarded. Thus, in a regular tax year, the individual taxpayer's income for "absorption" purposes will include all of his capital gain, just as does a corporation's.

Under the Tax Court's view there is also equality when the alternative tax applies. As shown in *Chartier* and *Sidney Axelrod*, neither a corporation nor an individual

suffers "absorption" without benefit. The "taxable income . . . to which such loss may be carried" for either type of taxpayer, under Respondent's view, excludes the capital gain segregated for separate taxation.

Thus, there is complete equality between individual and corporate taxpayers in this regard under either the regular tax or the alternative tax.

C. *Weil*, As Extended in the Ruling on the First Petition in *Chartier* Is Entirely Consistent with *Chartier's* Ruling on the Second Petition and With the Decision Below.

A close review of the portion of the Government Brief in which *Weil* is presented as significant (G.Br., pp. 30-32) shows that the argument is no more than a restatement of the contention that the mode of computing an NOL in the loss year, as specifically prescribed in Section 172(c), should be adopted as the mode for computing the effect of the NOL deduction in a "carry" year. As such, it calls for little response in addition to that made, in Point III A., *supra*, to the broader Section 172(c) argument by which it is encompassed. (Congress did not intend parallel treatment between the "loss" and "carry" years. Nor would the Government's position create such parallelism. See Table C.) Nonetheless, some comment is made appropriate by the structure of the Government's presentation.

Weil itself held only that where the alternative tax applies to a noncorporate taxpayer, a deficit in ordinary income for the year may not be used as a deduction from the capital gain component of the year's income. That conclusion merely reflected and was compelled by a marked difference in statutory language.[30]

The Tax Court in *Weil* found a clear purpose in the alternative tax provisions to remove all capital gain from the income component on which the partial tax was levied, thereby depriving it of the position in which it could be reduced by ordinary deductions, and to cause *all* capital gain to be taxed at a distinct rate. It also found a conspicuous absence of an intent, like that manifested in the 1924 Revenue Act, to permit the capital gain so separately taxed to be reduced by any deductions.

When in its *Chartier* decision in Dkt. 838-66, the first of the corporate taxpayer's two petitions before it, the Tax Court extended *Weil* to corporations in the "carry" years, it found the provisions of Section 1201(a) to be as explicit as those of Section 117(c)(2) of the 1939 Code which it had considered in *Weil*.[31]

The Tax Court's extension of *Weil* to "carry" years effectively compelled the decision on the taxpayer's second petition regarding the following year (Dkt. 2116-67): the portion of the NOL deduction deprived of effect in 1962 by the adoption of *Weil* had either to be held preserved

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30. The difference between (a) the language of Section 117(c)(2) of the 1939 Code, stating that when the alternative tax applies, "such excess" (meaning "what we refer to as taxable capital gain," 23 T.C. at 430) shall be *eliminated* from the income component to be taxed at regular rates, but that the capital gain rate shall be applied to the entirety of "such excess," and (b) the expressly contrary language of Section 208(b) of the 1924 Act (quoted in Point III. D., *infra*).

31. "The provisions of the statute are set forth with such specificity that they admit of no such reading as that urged by the petitioner which seems to subtract from 'such excess' that portion of the carryback loss that was not absorbed in the computation of the 'partial tax' in [Section 1201](a)(1)." 52 T.C. at 351.

to achieve its intended tax effect in another year (1965), or to be obliterated without tax effect as the Commissioner argued. The latter option was recognized as contrary to the purpose of Section 172, so the Tax Court, of course, rejected the Commissioner's contention, just as this Court should reject the Government's reiteration of the same position here.

As a subsidiary aspect of its argument on *Weil*, the Government suggests (G.Br., pp. 32-33) that the decision below creates a "preferred" position for NOLD's vis-a-vis other deductions from ordinary income, since same-year excess ordinary deductions may not otherwise be given effect against the capital gain component. The Government's suggestion may be attributable to its failure to recognize that the NOLD sought by Respondent is a carryback from 1968, and is not "preferred" or otherwise related to 1966 deductions.

There is nothing remarkable about an NOLD being "carried" from year to year when same-year deductions in excess of ordinary income are left behind and lost. It is the essence of Section 172 to give net operating losses effect in other years, once the conventional deductions in the loss year reach the threshold defined in subsection 172(c). Beyond the threshold, the deductions are given a new identity, and are treated as Section 172 prescribes. *Weil*, as extended in *Chartier*, then supports Respondent's position.

For these reasons the Government's reliance on *Weil* is misplaced, and there is no logical reason why the *Weil* rule makes it "anomalous" for Respondent to apply the remainder of its 1968 NOL to its 1967 ordinary income.

D. The Government and *Mutual Assurance* Misconstrue the Legislative History Which Contributed to *Weil*.

The Government makes its first and only discussion of any aspect of the legislative history in an additional argument, which it relegates to a footnote. G.Br., p. 31 n.19.[32] There it observes that "the Revenue Acts from 1924 to 1934" permitted ordinary deductions in excess of ordinary income to be deducted from capital gain, even when the alternative tax applied in the loss year. The Government then quotes from the opinion in *Mutual Assurance* to the effect that *Chartier* creates a situation more favorable to the taxpayer than Congress had during the 1924-1934 period by allowing excess deductions in the form of NOL's to be offset against ordinary income in other years.

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32. In another footnote (G.Br., pp. 33-34n.22), the Government vaguely attempts to use the results of *Lone Manor Farms, Inc.*, 61 T.C. 436 (1974), as a basis for undermining the *Chartier* result—notwithstanding that the Tax Court found *Chartier* inapposite there. *Lone Manor Farms* illustrates the effect of having a capital gain in a "carry" year and an NOLD which creates so large a deficit in ordinary income that the regular tax computation is more favorable. When the regular tax applies the NOLD is deductible from all "carry-year" taxable income, all of which is subject to Section 11 rates. However, once so used, an NOLD becomes unavailable for subsequent years. Thus, the unqualified direction of Congress that at a certain point a taxpayer must switch from one set of tax rates to another may have abrupt secondary effects in some cases; but that circumstance provides no support for the Government's position.

The actual result in *Lone Manor Farms* would be the same under either the Government's or Respondent's position; there is no dispute that an NOLD used in determining taxes under the regular computation, when it applies, is "absorbed." The question here is one of "absorption" in a year where the NOLD has created an ordinary income deficit such that the alternative tax applies. Here, the Government position creates "absorption" with no benefit, and causes a disruption of the purposes of Section 172 by producing the results hereinbefore illustrated in Table C.

However, both *Mutual Assurance* and the Government misconstrue the significance of the legislative provision in question, which first appeared as Section 208(b)(5) of the 1924 Act,[33] and which *Weil* had interpreted correctly (pp. 36-37 and note 30, *supra*). That provision introduced a term of art, "capital net gain," which it defined as:

> ". . . the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain."

This provision was reenacted by the 1926, 1928, and 1932 Revenue Acts,[34] but was absent from the 1934 and 1936 Revenue Acts which included no alternative tax in any form. No such provision was included when the alternative tax was revived for individuals by the Revenue Act of 1938. (A columnar chart showing the full capital gain and loss tax pattern from 1921 to 1942 appears as Appendix B.)

In its *Mutual Assurance*[35] opinion, the Fourth Circuit makes use of only part of the legislative history. The court reasoned as follows:

1. The structure of the alternative tax set forth in the Revenue Acts of 1924 through 1932 was such that any deficit in ordinary income would reduce the amount of capital gain subject to the second step of the alternative tax.

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33. Revenue Act of 1924, ch. 234, §208(b)(5), 43 Stat. 253.

34. Act of Feb. 26, 1926, ch. 27, §208(b), 44 Stat. 9; Act of May 29, 1928, ch. 852, §§101(a) and (b), 45 Stat. 791; Act of June 6, 1932, ch. 209, §§101(a), (c)(5), 47 Stat. 169.

35. *Mutual Assurance Soc'y* v. *Commissioner*, 505 F.2d 128, 136-38 (4th Cir. 1974).

2. When the alternative tax was revived for individuals in 1938, it contained no such provision. The Fourth Circuit refers to this as a "sharp contrast"[36] with the provision prevailing between 1924 and 1934.

Thus, concluded the Fourth Circuit, in the passage from which the Government quotes only the final sentences:

> "Such clear Congressional action in the past raises a negative inference from Congress' failure to enact similar provisions at a later date. This is particularly so where the court-fashioned remedy is more drastic than even that chosen by Congress on the prior occasion. Between 1924 and 1934, if a net operating loss exceeded net ordinary income for the year in which a deduction was allowed, the excess offset capital gains for such year, which were taxed at favorable rates. The Tax Court's remedy is a ruling that such excess will be available in the future to offset ordinary income. Thus, the Tax Court has extended a greater benefit to the taxpayer than Congress did when it expressly addressed itself to this problem on a prior occasion, and we think incorrectly so."[37]

The Court does not tell us what "negative inference" it believes may be drawn; but the only inference which may be validly drawn is that Congress intended the *Weil* result, i.e., that an ordinary loss cannot be used to reduce capital gain in making the alternative tax computation. No inference relating to loss carryovers is justified. The Fourth Circuit failed to consider that in 1938, when the alternative tax reappeared, there were no loss carryover

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36. *Id.* at 137.

37. *Id.* at 138 (footnote omitted).

provisions in the Code and there had been none since the passage of the National Industrial Recovery Act in 1933.[38] More pertinently, no inference regarding the corporate alternative tax can be drawn because there was no such tax until 1942.[39] During the periods to which the Fourth Circuit refers, corporate capital gains were taxed in the same way as operating income. Thus, correctly interpreted, the "negative inference" properly drawn was not significant to *Mutual Assurance* or here.

CONCLUSION

For the above reasons, the judgment of the Court of Appeals for the Eighth Circuit should be affirmed.

Respectfully submitted,

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38. See Appendix A.
39. See Appendix B.

APPENDIX A

LEGISLATIVE HISTORY OF LOSS CARRYBACK AND LOSS CARRYOVER PROVISIONS

Net operating loss carryover provisions first appeared in the Revenue Act of 1918,[1] which allowed a one-year carryback and a one-year carryforward. Senator Lenroot said in the Senate discussion of the provision,

> "It is something entirely new with reference to a taxation policy in the United States. It proposes instead of treating a taxable year as a unit to group them into two or three taxable years as the case may be."[2]

The Revenue Act of 1921[3] allowed no carrybacks but allowed carryovers to the first and second succeeding year. This provision continued until the Revenue Act of 1932 when, pressed for revenue and facing unprecedented corporate losses resulting from the depression, Congress reduced the carryover to one year only.[4] The Senate Finance Committee Report noted:

> "The net loss provision of the existing law is one of the essential protections against excessive hardships inherent in a tax based upon an arbitrary annual accounting."[5]

In the following year, however, the National Industrial Recovery Act eliminated all carryovers and carrybacks.[6]

1. Act of Feb. 24, 1919, ch. 18, §204(b), 40 Stat. 1061.
2. 57 CONG. REC. 513 (1918).
3. Act of Nov. 23, 1921, ch. 136, §204(b), 42 Stat. 231.
4. Act of June 6, 1932, ch. 209, §117(b), 47 Stat. 207.
5. S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932).
6. Act of June 16, 1933, ch. 90, §218(a), 48 Stat. 209.

They were not revived until 1939, subject to a slight exception in the Revenue Act of 1938.[7]

The Revenue Act of 1939 reenacted the two-year carryover provision of the 1920's.[8] The Ways and Means Committee report[9] made it clear that the operating loss carryover provisions were intended to equalize the taxes assessed against corporations having steady incomes and against those with fluctuating earnings pictures:

> "2. Net loss carry-over.—The bill, together with the committee amendments, permits taxpayers to carry over net operating business losses for a period of two years. Prior to the Revenue Act of 1932, such 2-year carry-over was allowed. No net loss has ever been allowed for a greater period than two years. In the Revenue Act of 1932, the 2-year net loss carry-over was reduced to one year and in the National Industrial Recovery Act the net loss carry-over was entirely eliminated. As a result of the elimination of this carry-over, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises. . . . An example will show the necessity for such a provision.

7. Act of May 28, 1938, ch. 289, §26(c), 52 Stat. 467. This provision allowed a minor tax credit which at a maximum could reduce future tax rates by 2 1/2 percentage points.

8. Act of June 29, 1939, ch. 247, §122(b), 53 Stat. 867.

9. *See* H.R. REV. No. 855, 76th Cong., 1st Sess. 3, 9, 16-17 (1939).

> "Suppose a corporation, over the 3-year period 1939-41, shows the following:
>
> | | |
> |---|---|
> | Net operating loss for 1939 | $2,000,000 |
> | Normal-tax net income for 1940 | 1,000,000 |
> | Normal-tax net income for 1941 | 1,000,000 |
>
> "Looking at this 3-year period, it will be seen that the corporation has not made any profit. However, assuming a flat rate of 18 per cent, it would be required to pay a tax of $360,000 if there were no provision for a net loss carry-over. Under the bill, a corporation in such a case would not be required to pay an income tax."[10]

For the first time since the relatively short-lived World War I provision, a carry*back* of a net operating loss was allowed by the Revenue Act of 1942,[11] thus expanding the loss availability period to two years before and two years after the loss year.

Further expansion lay ahead. The Revenue Act of 1950 changed the loss availability period to one year before and five years after the loss year.[12] The House Committee Report states,

> "One effect of this change is to extend the period over which business income can be averaged from 5 to 7 years, thus reducing the tax disadvantages which occur to businesses with fluctuating incomes. Such incomes are associated with unusual business risks and occur relatively frequently among small and new businesses. Hence the extension of the averaging period from 5 to 7 years will provide a real stimulus to venture capital

10. *Id.* at 9-10.

11. Act of Oct. 21, 1942, ch. 619, §153(a), 56 Stat. 847.

12. Act of Sept. 23, 1950, ch. 994, §215(a), 64 Stat. 937.

generally and to small and new business in particular."[13]

The Internal Revenue Code of 1954[14] retained the five-year carryover and extended the net operating loss carryback from one to two years. It also made changes in the method of computing net operating losses, eliminating adjustments which had been required for the receipt of tax-exempt interest and for the excess of percentage depletion over cost depletion. The 1954 Code also significantly added to the second sentence of Section 172(b)(2) the words ". . . to which the loss may be carried." No committee or other legislative commentary on the addition of these words has been found.

The carryback period was further extended in 1958 to three years, establishing the loss availability period as it still stands today, at three years before and five years after the loss year.[15]

The Senate Finance Committee in 1962 described the current loss availability period as follows:

> "Present law provides that business losses incurred in one year can be carried back to the 3 prior years and then, to the extent not absorbed by income in those years, carried forward to the 5 succeeding years after the year in which the losses occurred. For most companies which again earn income such a period is long enough to absorb all of their losses against income."[16]

A tabulation of the significant operating loss provisions, since 1918, appears on the following page.

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13. H.R. REP. No. 2319, 81st Cong., 2d Sess. 59 (1950).

14. Act of Aug. 16, 1954, ch. 736, §172, 68A Stat. 63.

15. Act of Sept. 2, 1958, Pub. L. No. 85-866, §203(a), 72 Stat. 1678.

16. S. REP. No. 1881, 87th Cong., 2d. Sess. 129 (1962).

SUMMARY TABLE
OPERATING LOSS DEDUCTIONS

Revenue Act of	Section Number	Period Effective: Beginning After	Period Effective: Ending Prior To	Carryback and carryover (number of years): Back	Carryback and carryover (number of years): Over	Notes
1918	204	10/31/18	1/1/20	1	1	
1921	204	12/31/20	1/1/24	0	2	
1924	206	12/31/23	1/1/25	0	2	
1926	206	12/31/24	1/1/28	0	2	
1928	117	12/31/27	1/1/32	0	2	
1932	117	12/31/31	1/1/33	0	1	(1)
NIRA (1933)	218	12/31/32	1/1/38	None	None	(2)
1939	23(s) 122	12/31/39	1/1/42	0	2	
1942	23(s) 122	12/31/41	1/1/50	2	2	(3)
1950	23(s) 122	12/31/49	1/1/54	1	5	(4)
1951	23(s) 122	12/31/47	1/1/50	2	3	(5)
		Years Ending After				
1954	172	12/31/53		2	5	
1958	172	12/31/57		3	5	

Notes:

(1) Losses carried over from 1931 only.

(2) Repealed Section 117 of 1932 Act. No loss carryovers to 1933.

(3) Amendments effective for years beginning after December 31, 1940, but carryback applies only to years beginning after December 31, 1941, and no carryback is allowed to year beginning prior to January 1, 1941.

(4) Table indicates effective period of carryback and carryover provisions. Amendment effective for years beginning after December 31, 1947.

(5) Also, added special provisions for new corporations. 1953 Act added provisions for certain fiscal years.

APPENDIX B

CAPITAL GAINS AND LOSSES
TAX PATTERN 1921-1942

Revenue Act of	Alternative Tax on Long-term Gain: Individuals	Alternative Tax on Long-term Gain: Corporations	Reverse Alternative Tax on Long-term Loss: Individuals	Reverse Alternative Tax on Long-term Loss: Corporations	Long-term Demarcation	Deductibility of Long-term Loss: Individuals	Deductibility of Long-term Loss: Corporations	Deductibility of Short-term Loss: Individuals	Deductibility of Short-term Loss: Corporations
1921	12½%	None	None	None	2 years	Full, subject to reverse alternative tax.	Full	Full	Full
1924			12½%						
1934	None		None		None. Varying percentages taken into account depending upon holding period.	$2,000 No distinction between long-term and short-term loss.	$2,000	$2,000 No distinction between long-term and short-term loss.	$2,000
1938	30%		30%		18 months	Full, subject to reverse alternative tax.	$2,000 (no distinction between long-term and short-term).	Not deductible against ordinary income.	$2,000 (no distinction between long-term and short-term).
1942	25%	25%	None		6 months	$1,000 (no distinction between long-term and short-term).	None	$1,000 (no distinction between long-term and short-term).	None

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